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CHARLES ELMORE

Supreme Court of the United States.

OCTOBER TERM, 1931.

No. 348

UNITED STATES CARTRIDGE COMPANY Petitioner,

v.

THE UNITED STATES.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

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I.

The Opinion of the Court Below.

The opinion in the Court of Claims is reported in 48 F. (2d) 983. It is printed at pp. 88–110 of the record in this case.

II.

Jurisdiction of this Court.

The jurisdiction of this Court is based on the Judicial Code, section 240, as amended by Act of February 13, 1925 (43 Stat. 936). The material portion of this section is as follows:

> "(b) In any case in the Court of Claims, including those begun under section 180 of the Judicial Code, it shall be competent for the Supreme Court, upon the petition of either party, whether Government or claimant, to require, by certiorari, that the cause, including the findings of fact and the judgment or decree, but omitting the evidence, be certified to it for review and determination with the same power and authority, and with like effect, as if the cause had been brought there by appeal."

The petition in the Court of Claims was brought to recover an alleged overpayment of taxes for 1918 amounting to $843,589.12, with interest. The petitioner alleged that the Commissioner of Internal Revenue had made three errors in computing the petitioner's income for 1918, namely, (1) an error in valuing a certain inventory called the Maxim or Italian contract inventory, (2) an error in refusing to allow a deduction of a portion of the cost of certain buildings and (3) an error in valuing certain inventories relating to contracts with the United States. There was, however, but one cause of action and the errors claimed affected merely the amount of the judgment to be entered, if any. The Court made special findings of fact and on those findings ruled in the petitioner's favor with respect to the first of the alleged errors and in favor of the United States with respect to the other two. Final judgment for the petitioner was entered in the Court of Claims on June 10, 1931, for $160,978.83 with interest (R. 200). The amount of this judgment corrected the first alleged error but not the second or the third. The petition for a writ of certiorari was filed on September 3, 1931.

III.

Statement of the Case.

A concise statement of the case has been made in the petition for certiorari under the heading, "Statement of Matters involved" (R. 1–10). In the interest of brevity the facts there stated are not repeated in this brief.

The following additional facts relate to the amounts of the taxes (excluding interest) and of the petitioner's income. All the taxes assessed have been paid (Special Findings 3–6, R. 59–60).

Total taxes assessed by Commissioner (Finding 4, R. 59) . . .	$1,152,123.53
Reduction by Court of Claims account Maxim (Italian) inventory question (R. 200)	160,978.83

Net tax according to decision of Court of Claims		$991,144.70
Net income as determined by Commissioner (Finding 4, R. 59)	$1,792,432.58	
Reduction in income account overvaluation Italian inventory ($274,659.78–79,297.11 — Finding 20, R. 66)	195,362.67	
Net income according to decision of Court of Claims	1,597,069.91	
Amounts involved in pending petition for certiorari:		
Deduction for cost of buildings (Finding 49, R. 79–80) $327,937.35		
U. S. inventory question ($732,088.62–231,615.43 Finding 41, R. 76) 500,473.19		
Total deductions claimed . . .	828,410.54	
Net income, after deducting items in dispute		768,659.37
Amount by which tax according to decision of Court of Claims exceeds entire net income as claimed by petitioner		222,485.33
Excess profits tax credit (Finding 4, R. 59) . . .		$369,464.68
War profits tax credit (Finding 4, R. 59)		461,080.84

Taxes on all income in excess of the war profits credit ($461,080.84) amount to 80% of such income for the war profits taxes and excess profits taxes, plus 12% of the remaining 20% of such income (or 2.4%) for income taxes, or a total of 82.4% of such income (Revenue Act of 1918, secs. 301(a), 230(a), 236).

It follows that the amounts of taxes involved in the pending questions are:

Cost of buildings deduction (82.4% of $327,937.35)	$270,220.38
U. S. inventory question (82.4% of $500,473.19)	412,389.91

IV.

Specification of Errors.

The petitioner contends that the Court below erred in the following respects:

1. The Court below erred in not allowing the petitioner a deduction of $327,937.35 from its gross income for 1918 on account of the cost of buildings erected by the petitioner on leased land, in addition to the deduction of $86,484.54 which was allowed by the Commissioner of Internal Revenue.

2. The Court below erred in denying to the petitioner a deduction from its gross income for the year 1918 on account of the cost of buildings erected by it on leased land in addition to the deduction of $86,484.54 allowed by the Commissioner of Internal Revenue.

3. The Court below erred in failing to rule that in determining the petitioner's income for the year 1918, the inventories of the petitioner on hand at the end of that year, which the petitioner had acquired for use under its contracts with the United States which had been suspended, should be valued at their market value on December 31, 1918.

The foregoing are the fundamental errors claimed by the petitioner which are intended to include the following subsidiary errors which are assigned:

4. The Court below was in error in holding and ruling that the use which was made by the petitioner of its buildings after 1918 was a bar to a deduction for obsolescence in addition to the deduction of $86,484.54 allowed by the Commissioner of Internal Revenue.

5. The Court below was in error in holding and ruling that under the terms of the cancellation clauses in the petitioner's contracts with the United States, the petitioner became entitled during the year 1918 to be paid for its inventories at cost.

6. The Court below was in error in holding and ruling that the inventories of the petitioner intended for use under its contracts with the United States should be valued as of the end of the year 1918 according to the amounts received for them in settlements made in later years.

7. The Court below was in error in holding and ruling that the decision of the Board of Tax Appeals in *Producers Fuel Co.*, 1 B. T. A. 202 was applicable to the case at bar.

V.

Argument.

This brief is directed to the question whether the writ of certiorari should be granted. Accordingly it will deal only with the main points involved. A summary of the argument is contained in the subject index at the beginning of this brief. Every effort has been made to condense the argument, although each of the two important questions involved requires separate treatment.

A. Certiorari should be granted to review the decision with respect to the deduction for cost of buildings.

The statute involved is section 234(a) of the Revenue Act of 1918 the material portion of which reads as follows:

> "Sec. 234 (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions . . .
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; . . .
>
> (7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;"

The principal regulations referred to by the parties are quoted in the opinion of the Court of Claims at pages 103–105 of the record. They include Regulations 45, arts. 143, 161 and 162.

The case now presented includes the following elements.

The petitioner constructed the buildings in question solely for war uses. It had no use for them for its normal peace-time business and had not been making any money in that business (Special Findings 43, 46, R. 77–78).

It constructed these buildings on leased land under an agreement that they should revert to the landlord at the end of the lease on December 31, 1924. Their usefulness to the petitioner was therefore bound to end by that definite date at the latest (Special Finding 44, R. 77).

These new buildings were all used by the petitioner up to the time of the Armistice and the petitioner had orders up to that time to its capacity and had no way of knowing when the demand for ammunition for war purposes would stop (Special Finding 47, R. 79). For that reason the petitioner was unable, up to the year 1918, to charge off in any year more than a proportionate part of the cost based on the charging off the total cost by December 31, 1924.

After the Armistice and as a result of it, the petitioner's officers had no expectation of continuing the manufacture of ammunition for war purposes for which the buildings had been built, and received no new orders for military ammunition and did not expect any (Special Finding 47, R. 79).

No income could be derived by renting the new buildings as there was no demand for buildings of this character (Special Finding 51, R. 81).

The new buildings had been so incorporated into the buildings rented by the petitioner from its landlord that the two had to be used as a unit unless the plant was revamped, and this was not considered or done (Special Finding 51, R. 81).

In an effort to get some return out of the buildings during the last six years of the lease (1919–1924) the petitioner used

them in its commercial (peace-time) ammunition business and for certain other new businesses which it attempted to carry on. None of these businesses proved profitable and the petitioner obtained no net return from these attempts to use the buildings (Special Finding 51, R. 81).

The depreciated cost of the buildings at the beginning of 1918 was $605,391.75. At the end of 1918 the actual value of the right to use the buildings for the remainder of the lease did not exceed $190,969.86 (Special Findings 49, 53, R. 79, 82).

Under these circumstances the petitioner charged off on its books for the year 1918 the difference between the depreciated cost, $605,391.75, and the residual value of its property, $190,969.86, or $414,421.89, and claimed a deduction of this amount in its income tax returns. The Commissioner of Internal Revenue ruled that the petitioner was not entitled to this allowance because it had not abandoned the buildings or permanently devoted them to a radically different use. He therefore allowed only $86,484.54 for depreciation of the buildings for 1918. This allowance was based on charging off an equal amount each year throughout the lease and took no account whatever of the change in conditions which resulted from the Armistice (Special Finding 49, R. 79–80). The result of the Commissioner's method is to allocate to the war years (1915–1918) $283,592.28, or 35% of the cost of the buildings, and to the later years $518,907.21 of this cost. The method used by the petitioner allocates $611,529.63, or about 76% of the cost to the war years and $190,969.86, or about 24% to the later years. In view of the facts that these buildings were built solely for war production and the petitioner at the time had no other use for them (Finding 46, R. 78) it is apparent that the latter method is more reasonable. An accurate accountant or business man would certainly charge off enough of the cost of such buildings at the end of 1918 so that they would be carried on the books for no more than their real value for peace-time purposes. The Court of Claims specifically found

that the value of the right to use the buildings for the remainder of the lease after December 31, 1918, did not exceed $190,969.86 (Special Finding 53, R. 82). Nevertheless, the Court sustained the Commissioner in allocating deductions to various years on a purely proportionate basis. The reasons assigned by the Court are discussed in connection with the points stated below.

1. The decision of the Court of Claims is inconsistent with the case of Burnet v. Niagara Falls Brewing Co., 282 U. S. 648, which is an authority in favor of the deduction claimed.

In *Burnet* v. *Niagara Falls Brewing Co.*, it was held that a corporation engaged in making beer was entitled to an allowance for obsolescence of its brewery buildings arising from national prohibition, although the company continued to use them in making soft drinks after prohibition went into effect. This case is similar in all essential respects to the case at bar.

The opinion of the Court of Claims distinguishes the *Niagara Falls Brewing Co.* case on the ground that that case was one where use of the buildings for the purposes intended was prohibited by law and the buildings were "not readily adaptable to other uses" (R. 108–109). It is submitted that this distinction is not sound. The opinion in the *Niagara Falls Brewing Co.* case clearly treats loss of trade as one of the changes which may result in obsolescence and also shows that the buildings in that case were adaptable to making soft drinks. (See opinion in *Burnet* v. *Niagara Falls Brewing Co.* 282 U. S. 648 at pages 652, 654.)

Another reason advanced by the Court of Claims is that the allowance of annual depreciation made by the Commissioner would eventually return the cost of the buildings and therefore no other allowance for obsolescence was necessary (R. 106, 109). This reasoning fails to distinguish between the ordinary allowance made on a time basis (depreciation and exhaustion) and obsolescence, which is a more rapid loss of value caused by change of circumstances. A tenant who erects buildings on

leased land which will become the property of the landlord at the end of the lease is entitled to proportionate annual allowances for exhaustion.

> *Duffy* v. *Central R. R. Co. of New Jersey*, 268 U. S. 55, cf. Art. 109, Regulations 45, printed at page 104 of record.

That is the nature of the allowance which was made in the case at bar by the Commissioner of Internal Revenue. The Commissioner and the Court of Claims have made no allowance for the complete change in the trade caused by the end of the war in advance of the time when allowances for "exhaustion" would equal the cost. *Burnet* v. *Niagara Falls Brewing Co.* is a clear authority for the allowance of obsolescence in the year in which property ceases, because of changes in trade, to be useful for the purposes for which it was built or acquired. It was undoubtedly true in that case that if no obsolescence had been allowed, the taxpayer might eventually have obtained allowances equivalent to the cost of its buildings through losses incurred on sales or through ordinary depreciation. That did not prevent the allowance of obsolescence, and should not prevent it in the case at bar.

Another reason relied on by the Court of Claims is that obsolescence should not be allowed when buildings are continued in use by their owner (Opinion, R. 105–109). It is submitted that this reasoning is entirely inconsistent with the decision in the *Niagara Falls Brewing Co.* case. In reply to the contention that obsolescence begins only when there is a reasonable certainty that the property cannot be used by the owner *for any purpose*, the opinion in the *Niagara Falls Brewing Co.* case states, "There is no hard and fast rule, as suggested by the Government, that a taxpayer must show that his property will be scrapped or cease to be used or useful for any purpose, before any allowance may be made for obsolescence . . . The company was unable to find any profitable use to which the prop-

erty could be put. The sums received on the sale and as rents constituted mere salvage." (See Opinion, 282 U. S. 648, at pp. 655, 656.) The decision in that case allowed obsolescence on a brewery although it was used after 1919 for making near beer and soft drinks and was subsequently rented.

The Commissioner of Internal Revenue cannot by regulations or otherwise lawfully impose a condition as to abandonment which is not found in the statute.

United States v. *George*, 228 U. S. 14.
International Railway Co. v. *Davidson*, 257 U. S. 506.
Campbell v. *Galeno Chemical Co.*, 281 U. S. 599, 610.

The Court of Claims also relied on a number of decisions of the Board of Tax Appeals (R. pp. 106–108). The objection to the use of these decisions as authorities is that they represent a line of cases inconsistent with the decision of this Court in the *Niagara Falls Brewing Co.* case. It should be noted that the *Niagara Falls Brewing Co.* case originated in the Board of Tax Appeals, and was there decided adversely to the taxpayer on the ground that no allowance for obsolescence on brewery property could be made where it was continued in use by the taxpayer after prohibition. (See *Niagara Falls Brewing Co.* 13 B.T.A. 1040 at 1049.) Prior decisions of the Board of Tax Appeals based on a similar rule were

Yough Brewing Co., 4 B.T.A. 612.
Star Brewing Co., 7 B.T.A. 377.
Tennessee Fibre Co., 15 B.T.A. 133.
Marigold Garden Co., 6 B.T.A. 368.
McCabe Lathe & Machinery Co., 9 B.T.A. 1137.

It would seem that until the Board of Tax Appeals has rendered a decision with respect to obsolescence which takes into account the decision of this Court in the *Niagara Falls Brewing Co.* case, citations from opinions of the Board of Tax Appeals on the issue now presented cannot be of assistance.

2. The fact that the petitioner's buildings became obsolete for the purpose for which they were built within a single tax year is not a bar to the deduction claimed.

It is not conceivable that Congress meant to give a deduction to a taxpayer who sustained a loss which occurred partly in one year and partly in another, and to deny such a deduction to another taxpayer who had a similar loss which all happened within one year. There was undoubtedly a period of several weeks before the Armistice in which it was apparent that the end of the war was near. It happened that this period fell entirely within the months of September, October and November, 1918. It might well have happened that the period would have included December, 1918, and January, 1919. There is no reason for applying different rules in the two cases. Obsolescence which ripens into obsoleteness within a single tax year is as clearly within the language of section 234 (a) (4) and (7) as is similar obsolescence which begins in one year and ripens into obsoleteness in the succeeding one.

3. The allowances made by the Commissioner of Internal Revenue in the years 1919–1924 on account of the cost of the buildings are not a bar to relief.

In the Court below it was argued for the respondent that if the petitioner should now obtain the allowances claimed for 1918 there would be a double deduction, as the Commissioner allowed for the years 1919–1924 deductions aggregating the amount which he disallowed for 1918. This argument ignores the findings that the allowances for later years were not claimed by the petitioner but were made by the Commissioner on his own motion as a result of his disallowances of the claim made for the year 1918; and that when he made this disallowance for 1918, the taxes for all the later years were still open, as the petitioner had waived the statute of limitations (Special Finding 49, R. 80–81). The state of affairs which now exists was one which the Commissioner deliberately created with all

the facts before him. He allowed these deductions in years when the rates of tax were so low that they made very little difference to the petitioner, and disallowed an equivalent deduction in 1918 when the taxes involved amounted to 82.4% of the deduction. The Commissioner could not, by forcing upon the petitioner deductions in later years which were not asked for, deprive the petitioner of a deduction to which it was entitled in 1918. Furthermore, the petitioner has no intention of obtaining a double deduction. Counsel was authorized to state, and did state in writing in the Court below, that if the deduction claimed for 1918 was finally established and a corresponding refund of taxes obtained, the petitioner would pay or cause to be paid such added amounts of tax, if any, as might be due for later years (either under the petitioner's returns or under consolidated returns which include the petitioner's income) because of any restatement of such deductions for later years which might be necessary in order to avoid duplication of the same allowance. Under this offer it is to be understood that in case taxes for later years have been finally settled, those years are to be opened up only as to items which the final judgment in this suit would result in changing and only to the extent that changes in such items are required as a result of such judgment.

B. Certiorari should be granted to correct the decision of the Court below with respect to the valuation of inventories under the contracts with the United States which were suspended.

The statute involved is section 203 of the Revenue Act of 1918 which reads as follows:

> "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commis-

sioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The material regulations are regulations 45, articles 22–24 and 1582–1584 (as amended by Treasury Decision 3296); and regulations 65, articles 1612–1614 (identical with said articles 1582–1584) and article 50. The material portions of these regulations are printed below at pp. 21–24. The facts with reference to the question now presented are stated in the petition at pages 5–10 of the printed record. These facts, together with the statutes and regulations referred to, establish the following propositions.

1. On December 31, 1918, this inventory did not include anything which was to be used to make such completed articles as were called for by the contracts.

The articles to be delivered under the contracts were cartridges and artillery primers. The inventories in question included only raw materials and work in process which were not needed in order to complete the limited number of finished articles which the suspension requests permitted the petitioner to furnish. (Special Findings 23–24, R. 69–70.)

2. On December 31, 1918, the petitioner had no contracts with the United States by which the United States agreed to accept these inventories and to pay for them at cost.

The opinion of the Court of Claims was apparently written in a belief to the contrary. The Court below states

> "The United States contracts clearly disclose 'firm sales contracts at fixed prices' and while the contracts were subject to cancellation, they contained express covenants upon the part of the United States to save the plaintiff

harmless in so far as the cost of materials, etc., entering into its inventory is concerned. The contracts contained express provisions setting forth with exactness how the plaintiff should be paid, and the items included within the Government's liability to pay (R. 97–98).

In reaching this conclusion the Court of Claims has overlooked the terms of the original contracts and of the suspension requests and the decision of this Court in *College Point Boat Corporation* v. *United States*, 267 U. S. 12. The contracts are listed on page 6 of the printed record. Copies are printed in the record beginning at pages 120, 132, 134, 146 and 163. The respective cancellation clauses of the contracts are printed at pages 125 (Art. V), 134 (Art. IV), 141 (Art. XIV), 153 (Art. VII) and 170 (Art. XIV). The suspension requests are printed as exhibits E, F, G and H at pages 52–56. The cancellation clauses gave the petitioner valuable rights in the event that the Chief of Ordnance elected to cancel the contracts (R. 6). The facts which are stated in the petition for certiorari at pages 6–7 of the printed record, clearly show that the Chief of Ordnance did not exercise the rights given by the cancellation clauses, but on the contrary expressly stated in the several suspension requests that these requests were made with a view to *negotiation of supplemental contracts* providing for the cancellation (or modification) of the existing contracts "*in a manner which will permit of a more prompt settlement and payment than will be practicable under the terms of said existing contract.*" (Italics ours. See suspension requests, R. 52–56.) The petitioner complied with the suspension requests (Special Finding 22, R. 69). As the original contracts contained no provisions for delivery of unfinished articles, except the cancellation clauses, and as the options to cancel were not exercised, it is impossible to support the conclusion of the Court of Claims that the settlements which were made involved merely the carrying out of the terms of the original contracts. *College*

Point Boat Corporation v. *United States*, 267 U. S. 12, is a conclusive authority against the proposition that these suspension requests exercised the options to cancel which were contained in the original contracts. (See petition for certiorari, at R. 13.)

3. On December 31, 1918, it was wholly uncertain whether the petitioner would reach any settlements of its contracts and whether, if it did, the settlements would involve the taking over of the inventories and payment for them at cost.

It is expressly found that on December 31, 1918, there was no way in which the petitioner could get cost for the inventories in question except by settlements with the United States. The materials were not salable at cost or at anything approaching cost (Special Finding 24, R. 70).

The suspension requests plainly contemplated negotiations looking toward some form of compensation to the petitioner on account of the cancellation of further deliveries. At the end of the year 1918 no one could know what form any settlements would take with respect to inventories, or whether the parties to a given contract would agree on a settlement.

Nothing happened in 1918 which gave the petitioner any assurance that the settlements, if made, would include the acceptance of the inventories by the Government and payment for them at cost. It was clear that the War Department did not want any more ammunition. There was nothing at the time to indicate that the War Department would adopt the policy which was later followed of taking over the enormous quantities of materials for ammunition which the various contractors had on hand, and setting up elaborate machinery for disposing of these materials, rather than leaving the materials in the hands of the contractors and making negotiated settlements with them as to their losses.

It is also to be noted that it was not until after 1918 that the War Department adopted a policy which permitted a partial

settlement for an inventory where the parties had not reached a complete settlement of a contract.

The date when the War Department adopted the policy of partial settlements for inventories was March 6, 1919 (Special Finding 26, R. 70). As the petitioner had important claims under each of the contracts in addition to those relating to its inventories, and as, at the end of 1918, it was wholly uncertain whether the parties would ever agree as to the settlement of any of these other claims, the prospects at that time for a settlement of its inventory claims were equally uncertain.

In the event that the petitioner was unable to agree with the War Department as to the terms of the settlement of any contract, its remedy, if any, would be only by suit in the Court of Claims for breach of contract. The Comptroller of the Treasury and the Comptroller General could not settle such complicated, unliquidated claims for breach of contract.

Power v. *United States*, 18 C. Cls. 263.

In any such suit it is clear that the judgment would not be that the United States should take the inventories and pay cost for them, but the petitioner would keep the inventories and, if it prevailed, would obtain a judgment for a sum of money to cover the petitioner's loss because the United States had failed to accept and to pay for the completed articles specified in the contracts.

United States v. *Behan*, 110 U. S. 338.
United States v. *United States Fidelity & Guaranty Co.*, 236 U. S. 512, 525.
Guerini Stone Co. v. *Carlin Construction Co.*, 248 U. S. 334, 343.

Furthermore there was doubt at the time and for several years afterwards as to whether the petitioner could treat a suspension request as a breach of contract where it had as-

sented to the request. The earlier decisions of the Court of Claims increased this doubt.

> *Dorris Motor Car Co.* v. *United States*, 60 C. Cls. 68, 78.
> *Savage Arms Corporation* v. *United States*, 57 C. Cls. 71, 85–86.

It was only after the decision of this Court in *College Point Boat Corporation* v. *United States*, 267 U. S. 12, which was handed down in January, 1925, that there was clear authority for treating such a request as a breach of contract in case negotiations failed.

4. Up to the time of the partial settlements made in 1920 the petitioner had no agreement that its inventories would be taken over and paid for at cost; and up to the time of the final settlements made in 1921–1922, the amount which the petitioner was to be paid was unliquidated.

The first proposition in this conclusion follows from the points which have already been stated and the last from the facts relating to the negotiations for settlement which are found in the petition for certiorari at pages 8–10 of the record. These facts show that on more than one occasion it appeared that any settlement of the petitioner's claims through the War Department was improbable, and that up to the time of the final settlements the amount of the claims was unliquidated.

5. Under the circumstances which have been stated the inventories should have been valued at their market value on December 31, 1918, ($231,615.43) and not at the amount ($732,088.62) which was realized for them in later years through the settlement agreements.

It is apparent from what has already been stated that what the petitioner had on December 31, 1918 was (1) inventories worth as merchandise $231,615.43, and in addition (2) claims for a much larger amount for reimbursement for the differ-

ence between the cost of its inventories and what they were worth as merchandise. The petitioner's chances for such reimbursement depended either on negotiations or on the outcome of a suit in the Court of Claims. As has been shown above, there was, on December 31, 1918, no ground for assurance as to the result of either negotiations or law suits. The petitioner contends that the Commissioner of Internal Revenue was not justified in valuing this merchandise as of December 31, 1918 at a figure which included its then present value plus the additional amounts eventually realized through the negotiation for the cancellation of the contracts.

a. The income which Congress intended to tax by the Revenue Act of 1918 was income which was so realized as to be available to the taxpayer according to ordinary business usage, and the petitioner's inventories were so available only at their market value.

The Revenue Act of 1918 imposed taxes running up to 82.4% of net income, which were payable during the year 1919. The inference is plain that Congress expected that taxpayers would have the income on hand out of which the taxes might be paid. It follows that the income intended to be taxed was something which, according to ordinary business practice, could be used to raise money with which to pay the taxes. Otherwise the result of the tax would in many cases be bankruptcy. The inventories in question were available at their market value for this purpose, as a basis for credit or by sale. They were not available at a price which included the additional amounts realized by the settlements which were made in later years.

b. The system of taxation contained in the Revenue Act of 1918 is based on an annual accounting period; and the petitioner's inventories should therefore be taken at their value at the end of 1918.

The decision of the Court of Claims was apparently based on the theory that the amount of the petitioner's taxes for 1918 might properly be kept open during the period of the statute of limitations and settled in the light of what the assets brought in later years within that period (See Opinion, R. 99–100). In support of this theory the Court relied on *Producers Fuel Co.*, 1 B.T.A. 202.

The objections to this treatment of the case at bar are that the Court below overlooked the general rule that taxes must be determined according to what takes place in the tax year, and also overlooked the fact that the *Producers Fuel Co.* case is only a narrowly limited exception to this rule, and does not apply to the facts in the present case.

The general rule is stated as follows in a recent opinion of the Supreme Court:

> "The Federal income tax system is based upon an annual accounting period. This requires that gains or losses be accounted for in the year in which they are realized.
>
> *Lucas* v. *Kansas Structural Steel Co.*, 281 U. S. 264, 268."

A later decision to the same effect is *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359.

Producers Fuel Co., 1 B.T.A. 202, was a case in which a purchaser repudiated a contract to buy goods in December, 1920, and in the same month admitted liability for the breach, began negotiations for settlement and set up a reserve for the amount of the damages. Settlements were made in January, 1921, by which the amounts to be paid were somewhat less than the reserve. The Board of Tax Appeals held that the purchaser might deduct a loss in 1920 but must substitute the amounts actually agreed on in settlement for the amount of the reserve. The decision has been limited to its special facts

by later cases in the Board of Tax Appeals which the Court below did not notice. The limited scope of the decision is recognized in *Lucas* v. *American Code Co.*, 280 U. S. 445 at pp. 449–450, as follows:

> "The Board of Tax Appeals has held, in a series of well-reasoned opinions, that a loss occasioned by the taxpayer's breach of contract is not deductible in the year of the breach, except under the special circumstances where, within the tax year, there is a definite admission of liability, negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued on the books."

The cases in the Board of Tax Appeals are collected in a footnote to the same opinion at page 450. It is clear that the *Producers Fuel Co.* case does not support the doctrine that an inventory may be valued at the end of a given year according to what is obtained for it in later years.

c. The decision of the Court of Claims is inconsistent with good accounting practice, which is recognized by the Revenue Act of 1918 and by the regulations as a standard.

The material portion of the Revenue Act of 1918 is section 203 which reads as follows:

> "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The regulations involved are Regulations 45, arts. 22–24 the material portions of which are as follows:

"Art. 22. Computation of net income.— Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year . . . The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income . . ."

"Art. 23. Bases of computation.—(1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income . . ."

"Art. 24. Methods of accounting.— It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. . . .

(1) In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor inventories of the merchandise on hand (including finished goods, work in process, raw materials and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year; . . ."

The provisions quoted clearly state the following propositions: (1) that it is the income *realized by the taxpayer within the taxable year* which is to be taxed; and (2) that standard accounting practice is ordinarily to be followed in determining this income.

According to standard accounting practice, inventories are a part of the quick assets of a manufacturing corporation. The excess of quick assets over current liabilities constitutes its working capital. The principal purposes of taking inventories and including them among quick assets are to give in-

formation to the management in laying out a financial policy; to give information concerning profits earned as a basis for dividends; and to give information to creditors as to what the company has with which to meet their claims. These purposes require that inventories should be treated as something which may be expected to be converted into current funds within a reasonable time for turnover. One of the principal reasons for listing quick assets separately is that creditors have as much right to know the availability of funds for meeting their debts when due as they have to know the ultimate value of the debts. If the officers of the petitioner had applied to a bank for a loan on December 31, 1918, and had obtained it on a statement that the inventories on hand, taken on the basis of "cost or market whichever is lower" were worth $732,088.62, knowing that they were worth as merchandise only $231,615.43, could the transaction be defended as honest? It is submitted that these inventories should be valued on the same basis for income tax purposes as for other purposes.

d. The decision of the Court of Claims is contrary to the particular provisions of the regulations which relate specifically to the valuation of inventories and to the proceeds of the settlement of claims on Government contracts.

The regulations involved are Regulations 45, articles 1582–1584 as amended by Treasury Decision 3296, and Regulations 65, article 50, which was in force when the petitioner's tax was determined in 1926. Articles 1582–1584 of Regulations 45 are identical with articles 1612–1614 of Regulations 65 which are printed in full as a part of the petition filed in the Court of Claims (R. 19–23). The portions of these regulations which have a direct bearing on the issue are as follows:

> "Art. 1582. Valuation of inventories.— The Act provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must

clearly reflect the income . . . An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

"The basis of valuation most commonly used by business concerns and which meets the requirements of the Revenue Act is (a) cost or (b) cost or market, whichever is lower. (For inventories by dealers in securities, see article 1585.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less cost of selling whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value . . .

"Art. 1584. Inventories at market.—Under ordinary circumstances, and for normal goods in an inventory, 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the case (a) of goods purchased and on hand, and (b) of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost . . ."

The material portion of article 50 of Regulations 65 reads as follows:

> "Art. 50. When included in gross income.—Gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included when they accrue to him in accordance with the approved method of accounting followed by him. See articles 21–24. If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in that year, assuming that the money or property would have been income in the earlier year if then received . . . *Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined.*" (Italics ours.)

It is submitted that the regulations required the petitioner's inventories to be valued at their market value on December 31, 1918. In the Court below the respondent relied on article 1584 as supporting the Commissioner's valuation, claiming that the "firm sales contract" exception found in that article applied, that the cost of the goods was received in the settlements, and that therefore the regulations had been followed in effect by valuing the goods at the amounts so received. The Court of Claims, having first assumed that the *original contracts* entitled the petitioner to receive cost for these inventories (an erroneous assumption—see this brief, pp. 13–15), treated the case as one of "firm sales contracts" (R. 97). It is submitted that the regulations are to the contrary.

In the first place, article 1584, in which the "firm sales contracts" exception is found, applies only to *normal* goods. As appears from the preceding article, 1582, "normal" goods are those which are salable at normal prices or usable in the normal

way. The petitioner's inventories were not "normal" goods; for the suspension requests had cut off all probability of using them in the normal way.

In the second place, the "firm sales contracts" exception in art. 1584, by its own terms, applies only to "goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e. those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, . . ." The inventories in question differ from those described in this article in three respects:

1. They were not goods on hand *for delivery*; for at the end of the year 1918 the parties knew that they would never be made into finished articles, and whether the United States would take delivery of them as a part of the settlement of the contracts was wholly uncertain. (See this brief, pp. 13–17.)

2. On December 31, 1918, the contracts were not "firm sales contracts" as defined by article 1584 in the words "those not legally subject to cancellation by either party." Performance under every contract had been cancelled by agreement. If, as the regulations recognize, even an unexercised right to cancel destroys the exception, accomplished suspension of production is certainly inconsistent with a "firm sales contract."

3. The contracts as they apply to these inventories were not contracts "at fixed prices entered into before the date of the inventory." The only contracts in existence on December 31, 1918, which called for delivery of goods at fixed prices were the original contracts, and the goods which they called for were completed articles. The cancellation clauses which might have applied to the inventories were inoperative, as has been shown above. (See this brief, pp. 13–15.) In the events which happened, the only contracts which provided for the payment for these materials at fixed prices were the settlement contracts made in 1920–1922. These were not made "before the date of the inventory."

Furthermore, the possible claims which the petitioner had

on account of the failure of the respondent to perform the original contracts are, under the regulations, clearly not income in 1918. Article 50 of Regulations 65, which was in force when the petitioner's taxes were settled, expressly provided:

> "*Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined.*" (Italics ours.)

This article is clearly in accord with the plan of taxation on which the revenue acts are based, as appears from a recent decision of this Court.

Burnet v. *Sanford & Brooks Co.*, 282 U. S. 359.

On December 31, 1918, the petitioner had inventories worth as merchandise $231,615.43, plus possible claims for breach of contract the value of which was uncertain. (See this brief, pp. 15–17.) By valuing these inventories at $732,088.62, the Commissioner included in income for the year 1918 $500,473.19 which was nothing but the proceeds of claims for the cancellation of the contracts which were not liquidated or settled until several years later. Under article 50 these proceeds should have been included in the income for later years and not in 1918 income.

e. The argument that valuing the inventories at market permits the petitioner to take a loss before it is sustained is not valid.

The objection to this argument is that it overlooks the distinction between inventories, which, according to the best accounting practice as exemplified in the "cost or market whichever is lower" method, should be brought down annually to actual current values, and capital assets, which should be carried at cost less depreciation (or exhaustion or obsolescence)

until they are sold or otherwise disposed of. The very purpose of the regulations in permitting the use of the "cost or market" valuation of inventories is to give the taxpayer the right to value them at prices less than cost when the market value is below cost.

C. The statutes and regulations should be liberally construed in favor of the taxpayer.

In the case at bar it is submitted that the statutes and regulations sustain the petitioner's contentions. If any doubt arises, however, they should be liberally construed in favor of the taxpayer (*Burnet* v. *Niagara Falls Brewing Co.*, 282 U. S. 648, at 654, and cases cited). It is respectfully submitted that the Court of Claims failed to observe this principle of construction.

D. The questions involved are of general importance.

The principles on which the decision of the case at bar must depend are of wide application. They apply as fully to the revenue acts subsequent to the Revenue Act of 1918 as they do to that act. Changes in industry are constantly compelling taxpayers to stop using property for the special purposes for which it was acquired. It is important that it should be settled by a decision of this Court whether a taxpayer who continues to use such property in order to get some return out of it loses all right to an allowance for obsolescence. The decision of the Court of Claims, unless it is reviewed by this Court, will leave both taxpayers and the Treasury Department in doubt as to allowances for obsolescence in cases where prohibitory statutes are not involved.

Questions like those involved in the valuation of the petitioner's inventories also affect a large number of taxpayers. Particularly in times of falling prices like the present persons engaged in trading or manufacturing are likely to have con-

tracts for the sale of goods which the purchasers are not willing to perform. It is important that the correct rule as to the valuation of inventories acquired for use in fulfilling such contracts should be settled by a decision of this Court. It is also of great importance in the administration of the tax laws that this Court should decide whether (as the Court of Claims has apparently decided) tax returns may be kept open and taxes determined according to events which happen in later years, or whether taxes must be assessed on the facts which exist at the end of the tax year.

VI.

Conclusion.

It is respectfully submitted that for the reasons stated in the petition for certiorari and in this brief this case calls for the exercise by this Court of its supervisory powers, in order that the construction of the revenue act in question and of later similar acts may be settled, that the conflict may be removed between the decision of the Court of Claims in the case at bar and the decisions of the Supreme Court of the United States which have been referred to in this brief, and that the petitioner may be relieved from a tax which largely exceeds its entire net income for the year 1918, if its income is determined in accordance with the evident purpose of the statute; and that accordingly the writ of certiorari should be granted.

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